

# Comparison and Future Prospects of Accounting Standards for SMEs in Japan

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## Abstract

The Guideline on Accounting for SMEs published on August 1, 2005 was not as widely used as originally expected. Consequently, the Basic Guidance on Accounting for SMEs was published by the Small and Medium Enterprise Agency and the Financial Services Agency on February 1, 2012. Moreover, the IASB had also published IFRS for SMEs in July 2009, in line with international trends. Thus, currently, there is confusion regarding the accounting standards for SMEs in Japan.

This paper compares the Guideline on Accounting for SMEs and the Basic Guidance on Accounting for SMEs and discusses the future prospects of accounting standards for SMEs in Japan.

## 1. Introduction

The first accounting standard for SMEs in Japan was the Bookkeeping Guidance for SMEs introduced on December 26, 1949<sup>1</sup>. This standard was introduced considering (1) the Financial Accounting Principles developed at the behest of the US and (2) the necessity of an accounting standard for not only large companies, but also SMEs. Further, the Guide Book of Bookkeeping Guidance for SMEs was published and a workshop was held on this topic.

Based on the Shoup Mission, Japan undertook tax reforms and introduced a self-assessed taxation system followed by the blue return system<sup>2</sup>. Bookkeeping was considered to be important because of the blue return system<sup>3</sup>.

Thereafter, among the several accounting standards, including those based on business law (Companies Act)<sup>4</sup>, the Securities and Exchange Act (currently known as Financial Instruments and Exchange Act), and the tax law, accounting focused on the definite-settlement-of-accounts principle-based tax law within the framework of the business law

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<sup>1</sup> The project history, needs, and characteristics of Bookkeeping Guidance of Accounting for SMEs and the blue return system were described in Financial Economy Public Relations (newspaper) No. 175 published on February 20, 1950.

<sup>2</sup> Kaneko (2013), 55-56.

<sup>3</sup> Yamamoto (1986), 12-15.

<sup>4</sup> In this paper, business law and Company Law are used interchangeably according to the time period under consideration.

(currently known as the Companies Act).

In recent times, there has been a strong tendency among financial institutes to lend funds to SMEs not through real estate mortgages, but based on their profitability. For SMEs to gain the trust of and borrow funds from financial institutions smoothly, and for the managers of SMEs to understand the financial condition of their own firms, an appropriate accounting standard is necessary<sup>5</sup>.

Consequently, the Study Group for Accounting for SMEs was established by the Small and Medium Enterprise Agency (SMEA) in 2002 and thus began the movement to develop an appropriate and unified accounting standard for SMEs. It was decided that SMEA, the Japan Federation of Certified Tax Accountants' Associations (JFCTAA), and the Japanese Institute of Certified Public Accountants (JICPA) would individually develop and present their accounting standards for SMEs. However, the presence of three different accounting standards led to confusion among SMEs regarding the appropriate accounting practice. Consequently, these three organizations resolved the differences in the accounting treatment among the three standards and the Guideline on Accounting for SMEs was published in August 2005.

However, this guideline was not as widely used as originally expected. Further, it was considered to be very different from the accounting practices adopted by SMEs. On February 1, 2012, the Basic Guidance on Accounting for SMEs was published to better reflect the accounting practices of SMEs<sup>6</sup>.

This paper explains the background to the development of the Guideline on Accounting for SMEs and the Basic Guidance on Accounting for SMEs, discusses their characteristics, and compares them. It also (Guidelines on Accounting of SMEs) discusses the future prospects of the accounting standards for SMEs in Japan.

## **2. Development of the Guideline on Accounting for SMEs**

### **2.1 Establishment of the exploratory committee for the integration of accounting standards for SMEs**

On March 23, 2005, JFCTAA, JICPA, the Japan Chamber of Commerce and Industry (JCCI), and the Accounting Standards Board of Japan (ASBJ) issued a press release on the establishment of the exploratory committee for the integration of accounting standards for SMEs<sup>7</sup>. This committee aimed at the integration of three reports—reports on accounting standards for SMEs by SMEA and JFCTAA and on accounting concepts for SMEs by

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<sup>5</sup> SMEA, *Study Group Report on Accounting Standards for SMEs*, June 2002, 4-13.

<sup>6</sup> FSA and SMEA, *Basic Guidance on Accounting for SMEs*, February 2012, 1.

<sup>7</sup> ASBJ, JCCI, JFCTAA, and JICPA, *Press Release, Establishment of the Exploratory Committee towards the Integration of Accounting Standards for SMEs*, March 23, 2005.

JICPA<sup>8</sup>. It must be noted that the goal of this committee was not the development of new accounting standards but the integration of the accounting standards prescribed by these three organizations.

## **2.2 Introduction of the accounting advisor system**

The accounting advisor system was introduced in Chapter 374 of the Companies Act published in July 2005. It prescribed that financial documents should be created by an accounting advisor in cooperation with a director. In general, SMEs lack internal control and managers tend to take arbitrary decisions. Consequently, SMEs were not easily trusted and could not borrow funds smoothly.

In order to improve the reliability of the financial statements published by SMEs, the Companies Act mandated the introduction of an accounting advisor. The necessity of reliable accounting standards led to the guideline on the practice of accounting advisors.

## **2.3 Publication of the Guideline on Accounting for SMEs<sup>9</sup>**

On August 3, 2005, JFCTAA, JICPA, JCCI, and ASBJ issued a press release The Publication of the Guideline on Accounting for SMEs. The exploratory committee for the integration of accounting standards for SMEs released the results of its study as a public draft on June 13, 2005 and the Guideline on Accounting for SMEs was finalized by the committee on August 1, 2005.

## **2.4 Goal of the Guideline on Accounting for SMEs**

The goal of the Guideline on Accounting for SMEs was defined as “the guideline of accounting treatments and annotations to be relied on by SMEs in creating financial documents<sup>10</sup>.” It is desirable that financial documents prepared by firms with accounting advisors conform to the Guideline on Accounting for SMEs and are of a certain quality.

The Guideline on Accounting for SMEs was created as one of those corporate accounting standards that are generally accepted as fair and valid.

## **2.5 Target firms of the Guideline on Accounting for SMEs**

The Guideline on Accounting for SMEs is targeted at SMEs— a SME is a listed company that is not a “company to which the securities law was applied, and its subsidiary and associate company” and a “major company defined by the Act on Special Measures for the Commercial Code and its subsidiary company.” The JFCTAA’s Research Report of

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<sup>8</sup> *Ibid.*

<sup>9</sup> *Ibid.*

<sup>10</sup> ASBJ, JCCI, JFCTAA, and JICPA, *Guideline on Accounting for SMEs*, August 3, 2005, 2-3.

Accounting Standard for SMEs and JICPA's Research Report of Accounting Concepts for SMEs targeted a wide range of companies, including mid-sized companies. It seems that the Guideline on Accounting for SMEs includes mid-sized companies based on these two reports.

## **2.6 Principles of the Guideline on Accounting for SMEs**

The roles of the Guideline on Accounting for SMEs are as follows: (1) supporting decision-making by investors, (2) aiding coordination among stakeholders, and (3) assisting business managers in accurately understanding and managing their businesses.

The basic idea of the Guideline on Accounting for SMEs is as follows: Irrespective of the size of the company, accounting treatments should be the same if the actual business conditions are the same. However, the simplification and application of the accounting treatment prescribed by the corporate tax law was accepted from a cost-benefit perspective so that it could be applied as a rule for SMEs. As stated in JICPA's Research Report of Accounting Concepts for SMEs and SMEA's Report about the Accounting Standard for SMEs, there should be a single accounting standard, and the simplified method that took into consideration the special characteristic of SMEs was accepted. In this regard, ideas from both the reports were taken into consideration.

Moreover, two conditions were stated in the Guideline on Accounting for SMEs regarding the application of the treatments prescribed by the corporate tax law. First, in the absence of an accounting standard, the result from the treatment prescribed by the corporate tax law reflects the actual economy. Second, an accounting standard exists but there are no significant differences between the treatment prescribed by the corporate tax law and the standard. It seems that the treatment prescribed by the corporate tax law is accepted in the Guideline on Accounting for SMEs because JFCTAA's Research Report of Accounting standard for SMEs promotes greater use of tax law regulations. However, the idea of a single accounting standard as proposed in JICPA's Research Report of Accounting Concepts for SMEs is the basis of the Guideline on Accounting for SMEs. The standard based on the corporate tax law has certain limitations.

## **3. Development of the Basic Guidance on Accounting for SMEs**

### **3.1 Background**

The background of the development of the Basic Guidance on Accounting for SMEs is discussed in detail below<sup>11</sup>.

SMEA set up the Study Group for Accounting for SMEs in February 2010, while ASBJ conducted meetings on the accounting standard for unlisted companies in March 2010. In September 2010, ASBJ and the other organizations published the report 'Meeting on the

Accounting Standard for Unlisted Companies’ and SMEA published the ‘Interim Statement of the Study Group on the Accounting Standard for SMEs’.

Further, SMEA and FSA conducted a review meeting on the accounting standard for SMEs in February 2011 to determine (1) the content of the standard in order to ensure its popularity and (2) the manner of utilization of the accounting standard by SMEs. This committee discussed the comment letters on the draft of the Basic Guidance on Accounting for SMEs.

Thus, the Guidance was developed based on the discussions by the committee and the working group. On February 1, 2012, SMEA and FSA published the Basic Guidance on Accounting for SMEs. The Guidance aims to balance accounting and law; its goal is to ensure that accounting conforms to the Ordinance on Company Accounting<sup>12</sup>. The Guidance was developed as a standard that reflects the accounting practices of SMEs and supports managerial decision-making.

### 3.2 Basic Principles

The basic principles of the Basic Guidance on Accounting for SMEs<sup>13</sup> are as follows: (1) the effects of IFRS should be avoided, (2) the principle of final accounts should be maintained, (3) accounting treatments based on corporate tax law should be taken into consideration, and (4) managers of SMEs should be able to understand the financial condition of their companies.

## 4. Comparison between the Guideline on Accounting for SMEs and the Basic Guidance on Accounting for SMEs

The differences between the accounting treatments prescribed in the Guideline on Accounting for SMEs and the Basic Guidance on Accounting for SMEs are discussed below.

The Guideline on Accounting for SMEs is too advanced for the key users, the accounting advisors of SMEs, especially regarding deferred tax accounting, inventory assets, and securities, among others.

The Basic Guidance on Accounting for SMEs circumvents the effects of IFRS, maintains the principle of final accounts, enables managers of SMEs to understand the financial condition of their companies, and recognizes the importance of bookkeeping by SMEs.

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<sup>11</sup> FSA and SMEA, *Installation of the Review Meeting about the Accounting Standard for SMEs*, February 2011.

<sup>12</sup> FSA and SMEA, *Basic Guidance on Accounting for SMEs*, February 1, 2012, 1.

<sup>13</sup> Kawasaki (2011), 39.

**Table 1. Comparison between the Guideline on Accounting for SMEs and the Basic Guidance on Accounting for SMEs**

Account transaction	Guidelines on Accounting for SMEs	Basic Guidance on Accounting for SMEs
Securities	Categorize based on holding purpose; evaluate trading securities and for sale securities using the fair value method.	Evaluate based on cost as a rule; in special cases, evaluate trading securities using the fair value method.
Inventory	Accept most recent purchase method with conditions. Request lower of cost or market value method with conditions.	Accept most recent purchase method. Option to evaluate based on cost or the lower of cost or market value method.
Fixed assets	Depreciation is conducted regularly.	Reasonable depreciation is conducted.
Deferred assets	Request to immediately categorize the research and development cost as a fixed cost.	No rules pertaining to research and development costs.
Foreign currency deals	Convert foreign currency financial receivables and payables using the exchange rates on the accounting date.	Accept the conversion of foreign currency financial receivables and payables using the exchange rates on the acquisition date.
Leases	Based on the sales transaction.	Selectively apply the sales transaction or the lease transaction.

Source: Guidelines on Accounting for SMEs published by ASBJ, JCCI, JFCTAA, and JICPA (2005); Basic Guidance on Accounting for SMEs published by FSA and SMEA (2012).

The Basic Guidance on Accounting for SMEs strongly reflects the corporate attributes of SMEs. These corporate attributes have already been highlighted in the report Workshop on Accounting for SMEs published by SMEA in June 2002. Thus, it seems that the Basic Guidance on Accounting for SMEs is based on this report in this regard.

## **5. Actual condition of SME financing in Japan<sup>14</sup>**

An accounting standard for SMEs in Japan is required to (1) enable managers and financial institutes to know the companies' financial situation and (2) provide financial documents to financial institutions such as banks in order to help them understand

<sup>14</sup> This section draws on the results of the interviews with tax accountants and financial institutions conducted by the author in March 2014.

companies' future profitability and managerial soundness and to draw funding. Thus, investments do not need to be secured by real estate mortgages.

Borrowings from financial institutions (banks) are at the center of fundraising activities by SMEs. The scorings by these institutions determine the funding extended to SMEs.

These scorings are not credit scorings. Rather, these institutions value the company's properties and debts and the manager's properties using the fair value method.

Each financial institute prepares its own scoring based on The Investigation Manual of the FSA<sup>15</sup>. These institutes are questioned by the FSA during inspections as to whether they conduct their financing activities based on the manual. However, the original purpose of establishing accounting standards for SMEs was to stop fund-raising through real-estate mortgages, but this has not been accomplished.

## 6. Conclusion

This paper discusses the background of the development and the contents of the two accounting standards for SMEs in Japan.

Both the Guideline on Accounting for SMEs and the Basic Guidance on Accounting for SMEs in Japan were expected to co-exist. The Guideline on Accounting for SMEs was effected from the IFRS and tends to be informative since it was developed using the top-down approach. In contrast, the Basic Guidance on Accounting for SMEs strongly reflects the corporate attributes of SMEs, avoids the effects of SMEs, and favors business management since it was developed using the bottom-up approach. Currently, there is a move to develop the two accounting standards for SMEs in Korea and the US using both the top-down and the bottom-up approaches<sup>16</sup>. This is because they could not address the diversity of SMEs only through the accounting standard developed using the top-down approach<sup>17</sup>.

In the Basic Guidance on Accounting for SMEs, the target companies are not limited by eliminating companies such as those with accounting advisors. Achieving a good balance between the Guideline on Accounting for SMEs and the Basic Guidance on Accounting for SMEs is an issue in Japan.

In the future, it is assumed that only the Basic Guidance on Accounting for SMEs that is based on the historical cost method will prevail.

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<sup>15</sup> FSA, *The Investigation Manual of the Financial Services Agency*, 2013.

<sup>16</sup> Kawasaki (2013), 9-12. American Institute of Certified Public Accountants (AICPA), *Financial Reporting Framework for Small- and Medium-Sized Entities Exposure Draft Available for Comment*, November 1, 2012. Sugimoto and Cho (2011), 17. Korea KPMG, *Japanese Practice Weekly Newsletter*, May 7, 2012.

<sup>17</sup> Ministry of Finance, Policy Research Institute, *Statistics of Business Corporation Research*, 2011. SMEA, *White Paper on Small and Medium-sized Businesses*, 2013.

This is because SMEs cannot respond to changes in the accounting treatment with the transition to IFRS and fair value accounting.

The Guideline on Accounting for SMEs may continue to exist for the following reasons.

Since the preferential treatment system for the introduction of the accounting advisor system will continue to be maintained, it is possible that the somewhat large SMEs will introduce the accounting advisor system and apply the Guideline on Accounting for SMEs. In contrast, the smaller SMEs are expected to apply the Basic Guidance on Accounting for SMEs because the discount system prescribed by this standard was introduced by the Credit Guarantee Association. So long as the accounting advisor system exists, the applicability of the Guideline on Accounting for SMEs will remain.

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